GOVERNMENT OF ALBERTA

ALBERTA'S CREDIT UNION SYSTEM

DIRECTIONS FOR REFORM

A DISCUSSION PAPER

Alberta

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Provincial Treasurer
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Introduction

For a half century, the credit union system of Alberta has performed an important role in the economic development of the province as a part of the co-operative system. With the rapid growth of the provincial economy, the credit union system expanded and entered into new endeavours such as commercial lending and commercial real estate financing. With the downturn of Alberta's economy in the early 1980's, particularly the drop in real estate values, the credit union system faced a crisis of confidence due mainly to heavy losses from residential and commercial mortgages. The Government of Alberta responded to this crisis by assuring deposits held in the system and by establishing a Task Force chaired by an individual with extensive experience in the credit union movement. In September, 1985, the "Report and Recommendations of the Minister's Task Force on Credit Unions" was released; the Report analyzed the problems facing the credit union system and recommended changes to its structure and operations.

Over the past two years, the government, the Credit Union Stabilization Corporation ("CUSC"), the Credit Union Federation of Alberta ("Central") and Alberta's credit unions have worked to stabilize the system. Under the co-ordination of CUSC, these efforts are continuing and the government believes these steps have developed a new confidence in the financial health of the system which will allow credit unions to move forward with greater confidence. It is timely, therefore, to amend credit union legislation to prepare for the challenges of the late 1980's and beyond.

This discussion paper outlines the main policy changes to be incorporated in a new Credit Union Act to be tabled in the Legislative Assembly later this Spring. The government welcomes input from the credit union system and other interested groups on these policy proposals.

It is proposed that the new legislation will be made effective on November 1, 1987. This date coincides with the commencement of the credit unions' financial year and will provide an opportunity for consultations on the Regulations prior to the date the legislation becomes effective.

The new legislation will be based on the following main objectives.

1. To modernize the regulatory framework to adapt to variable economic circumstances faced by the credit union system.

2. To enable credit unions to remain competitive with other types of financial institutions.

3. To provide an appropriate structure for both the Credit Union Stabilization Corporation and the Credit Union Federation of Alberta.

4. To develop the most up-to-date concepts concerning credit union legislation and to incorporate, where appropriate, provisions from the legislation of other jurisdictions.

This paper is organized into three sections. Section I describes the role, responsibilities and powers of the government, CUSC and Central. Section II sets out proposals for internal administration of credit unions including credit union powers, the role and responsibilities of directors and auditors, controls on the mix of loans, and new provisions for incorporation and the commencement of business. Section III outlines enhanced regulatory requirements with respect to borrowing, equity and loans to members.

I. Organization of the Credit Union System: Role, Responsibilities, Powers

A. The Government

The government's main function with respect to the credit union system is to provide the framework within which the individual components of the system function and to monitor the financial health of individual credit unions. Historically, the role of government in the credit union system has been to incorporate new credit unions, to examine individual credit unions and Central, and to place credit unions under supervision or administration under exceptional circumstances. These basic powers will be continued.

Under the new Act, the government's role, responsibilities and powers will be to: incorporate new credit unions; authorize the commencement of business; place credit unions under supervision or administration when necessary; examine, on an annual basis, the financial affairs of credit unions; conduct special examinations; issue cease and desist orders; and prescribe regulations respecting, among other things, liquidity requirements for credit unions.

With respect to incorporation, the Minister alone will be responsible for incorporation. Prior to the commencement of business the credit union must obtain the approval of CUSC which will insure the

deposits and participatory savings accounts (formerly "share savings").

Under the present legislation, CUSC could independently place a credit union under supervision or administration. The new legislation will clarify the responsibility of the Minister in approving the appointment of a supervisor or an administrator. The Minister alone may place Central under supervision or administration. CUSC will be granted the power to place a credit union under supervision, but may place a credit union under administration only with the approval of the Minister.

In addition to the current powers to examine a credit union, the Minister will be empowered to conduct a special examination, inspection or audit in order to safeguard the interest of members.

Consistent with new legislation in other jurisdictions, the Minister will be empowered to issue "cease and desist" orders with respect to credit unions and Central where certain practices are endangering the financial soundness of a credit union or Central. These actions will be subject to the right of appeal. In addition, certain administrative actions will be subject to appeal as provided for under the legislation.

The Minister, through the Regulations, will be permitted to establish the minimum level of funds (which may vary by type of deposit liability) a credit union must invest with Central for liquidity purposes.

B. Credit Union Stabilization Corporation

The government is considering making CUSC a provincial Crown corporation in recognition that its members are appointed by the provincial Cabinet, to ensure that the financial resources made available through the refinancing program are adequately controlled and the activities of CUSC are in conformity with government policy.

The Board of Directors will continue to be appointed by Cabinet and its membership may be enlarged to seven members. Members will be appointed for a term of up to three years and will serve at the pleasure of the Lieutenant Governor in Council.

CUSC will be the system's guarantor of deposits and participatory savings accounts. Previously, CUSC guaranteed deposits and equity accounts. Recognizing the importance of CUSC's role in standing behind deposits held in the system, initially

all deposits and participatory savings accounts will be guaranteed by CUSC. However, the government is contemplating the setting of a maximum level of insurance per account which would not be implemented until November 1, 1992, or later. This policy is sensitive to the present difficulties facing the system by continuing the present financial arrangements while reflecting the desire of the government to institute a regulatory system which imposes some discipline on these deposit-taking institutions. In this role, CUSC will be responsible for managing and maintaining the integrity of the Stabilization Fund.

CUSC will continue to act as supervisor or administrator of credit unions subject to the approval of the Minister. To protect the integrity of the Fund, CUSC will be empowered to place under supervision a credit union which has borrowed 20% or more of its deposits and equity base.

At the present time, CUSC is in the process of approving credit union equity programs. CUSC will continue to work very closely with individual credit unions on the reconstruction of their equity base and will be responsible for the equity building program. The Minister will establish the general parameters through the Regulations for the implementation of such programs. (For a more detailed discussion see "Equity Program" under Section III.)

One of the ongoing functions of CUSC will be to levy an assessment or premium on credit unions. Provision will be made in the legislation to permit incentive premiums to be levied. The criteria for these incentive premiums will be prescribed in the Regulations and will be related to the credit union's equity base. The objective is to provide an incentive for credit unions to build up their equity base as quickly as practicable which, in turn, will minimize the risks to the Stabilization Fund.

In order to maintain the stability of a credit union's equity base, the new legislation will constrain the redemption of common shares in certain circumstances (e.g., insolvency) and will require the authorization of CUSC for the redemption of common shares where such net redemptions exceed 10% of the outstanding common shares at the end of the previous fiscal period.

CUSC will be authorized to initiate and undertake a special financial examination of a credit union if necessary. Finally, consistent with current practices, CUSC will provide Special Loan Committee functions for every credit union. This committee will

be responsible for approving loans above a prescribed level.

C. Credit Union Federation of Alberta

The new Credit Union Act will integrate the Credit Union Federation of Alberta Act, continue Central under the new Act, and set out objects and powers for the Federation. Powers proposed by the Task Force and to be included in the new Act include: the authority to lend to members; deposit-taking powers; the ability to assess dues and to create subsidiaries and acting as "central banker" to credit unions. In addition, the legislation will set out the qualifications, responsibilities, liabilities and remuneration of directors. These provisions will be similar to the requirements for directors of credit unions.

The Minister will prescribe a minimum level of assets to be deposited with Central which will vary according to the type of deposit liability. Transitional provisions will be legislated to minimize problems associated with the movement towards a more flexible liquidity system. For small credit unions, funds for liquidity purposes may be kept with authorized financial institutions, with the Minister's approval.

II. Credit Unions

A. General

Credit unions will be given the powers of a natural person. Existing credit unions will be required, within two years, to file new "articles of continuance" with the Minister outlining certain required information, including information on share structure.

Credit unions with assets of $1 million or more will be classified as "large" credit unions; credit unions with assets of less than $1 million will be classified as "small" credit unions. This classification is primarily for matters of internal governance, audit and financial reporting.

New provisions will be incorporated respecting unclaimed deposit balances. The legislation will parallel the Bank Act to ensure that efforts are made to inform members of unclaimed balances. After a 5 year period these balances will be transferred to CUSC.

B. Incorporation

The legislation will provide that the start-up of a new credit union proceed in two stages: incorporation and the commencement of business. A group of not less than 10 incorporators may submit an application to the Minister for incorporation. The Minister may approve or reject the application and may state the reasons for so doing in the latter case. Prior to the commencement of business, the credit union's incorporators must enroll 250 members, enlist subscriptions for common shares of $250,000 and hold in trust $750,000 in term deposits. These minimum requirements will be prescribed in the Regulations and may be adjusted from time to time. Alternative requirements may be specified for closed bond associations. In addition, prior to commencement, CUSC must approve the credit union for membership and notify the credit union and the Minister that the deposits and participatory savings deposits will be guaranteed.

C. Loans and Investments

Credit unions will continue to lend to members and to customers who are non-members (e.g., municipalities and private corporations). The ability to repay a loan without a prepayment penalty will be limited solely to consumer loans to limit the exposure of the mismatching of assets and liabilities.

Consistent with the Task Force's recommendations, portfolio limits will be established for each loan category for individual credit unions to minimize problems arising from an over-concentration of loans in certain types of lending, especially commercial lending. Regulations will define several categories of credit unions for the purposes of establishing the portfolio mix. These loan limits will set out the maximum percentage for commercial, consumer, residential and agricultural loans, and commercial real estate in a credit union's portfolio. In addition, loans to members will be subject to certain restrictions as outlined in Section III.

The provisions for other types of investments will be modernized. Current investments deemed ineligible under the new Act will be "grandfathered".

D. Directors

The new Act will provide for minimum qualifications for directors, and a standard of care and diligence. Certain types of persons will be disqualified from serving as a director (e.g., an individual with the status of a bankrupt). Directors must also be

Canadian citizens or landed immigrants, ordinarily resident in Alberta. As recommended by the Task Force, the legislation will provide for compensation for directors subject to a maximum level prescribed by the Regulations.

Directors' liabilities, jointly or severally, will be outlined along with certain specified offences. Directors will be liable and subject to offences under the Act for, among other things: payment of dividends where a credit union's financial position is unsound; actions taken which are contrary to the Act and by-laws; or cases where a director has an interest in a contract or is in any other conflict of interest. Directors may be indemnified by the credit unions under particular circumstances where they have acted in accordance with their duties. Directors who formally dissent from particular Board decisions may not necessarily be held liable and consequently may not be subject to an offence.

E. Committees

The government proposes the establishment of three Board committees: the finance, audit, and credit committees. (In the case of a small credit union, the Board of Directors may perform the function of all three committees.) The finance committee will, among other things, review financial policies and procedures and the credit union's budget. The audit committee will, among other things, review the scope and conduct of internal audits, ensure compliance with management procedures and credit union by-laws, ensure external audits are conducted in compliance with generally accepted accounting principles, recommend appropriate procedures to the Board and direct any special audit or examination required by the Board. Credit committees will inquire into the financial condition of loan applicants and the security or guarantee pertaining to a loan, and provide final approval subject to the special loans provisions.

F. Auditors/Financial Reporting

A qualified auditor must be appointed annually to audit the operations of a large credit union. Small credit unions must continue to prepare annual financial statements to be submitted to members and to the Minister. In addition to the auditor's traditional reporting responsibilities to the annual meeting and to the Minister, the auditor will be required to inform the Minister of any transaction of a material nature which comes to his attention, in the course of his audit, and which contravenes the Act or which reflects unsound financial practices. Auditors

will be required to prepare a management letter annually to go to both the Minister and the audit committee. The auditor will be entitled to attend any annual or special meetings and any meetings of the audit committee.

In the event that the auditor is removed or dismissed by the credit union, notice of his removal is to be provided to the Minister. The Minister will also be empowered to inquire into the reasons for the auditor's dismissal. The government will be discussing these measures with representatives of the accounting profession in the near future.

Over the past several years, the credit union system and the accounting profession have voluntarily adopted generally accepted accounting principles and accounting policies developed especially for credit unions by the Canadian Institute of Chartered Accountants. It is the intention of the government to recognize these accounting policies to ensure that financial statements fully reflect credit unions' financial circumstances.

G. Trustee Powers

At present, credit unions are prohibited from acting as trustee for Registered Retirement Savings Plans (RRSPs) and must use the services of other institutions to offer this service. The government proposes to extend limited fiduciary powers to credit unions and to Central in respect of RRSPs. In the interests of consumer protection, this extension will be conditional upon the applicant satisfying the Minister that it has the requisite expertise to provide these services. Further powers may be accorded to Central and individual credit unions in the future on this basis.

III. Regulatory Framework

Major regulatory changes contemplated will include new controls on borrowing, an equity building program and provisions governing loans to credit union members and connected persons. All of these measures will be monitored during the Minister's annual examination, special audits or in conjunction with CUSC's powers of supervision and administration.

A. Borrowing

The Task Force Report noted that during recent periods of rapid economic growth, credit unions began to fund an increasing portion of their loans by borrowing from Central rather than funding through

deposits. The Task Force accordingly recommended controls on this type of borrowing.

The new Act will restrict borrowing from Central to that required for general liquidity purposes and to meet demands which may be caused by local, seasonal or temporary needs of their members as established under the credit union's annual operating plan. Borrowing for the acquisition of assets with a term to maturity of greater than 12 months will be prohibited unless the Minister approves. When borrowing from Central exceeds 15% of deposits plus equity, for a period of 15 consecutive days, Central will be required to notify the Minister and CUSC. At this stage, a credit watch will be instituted. When borrowing exceeds 20% of deposits plus equity, CUSC or the Minister may place the credit union under supervision.

B. Equity Program

One of the key conditions established by the government as a result of the major re-financing of the credit union system was the institution of an equity program. The purpose of this program is to build a strong equity base in all credit unions.

The legislation will require existing credit unions to achieve, within a 10 year period, an equity base equal to 5% of assets. Existing credit unions must establish equity programs, subject to the approval of CUSC. The program's objectives may be met in several ways, including: transfer of current equity accounts; application of retained earnings; injection of new capital; or a combination thereof.

Related to the implementation of the equity program, a number of changes will be made to distinguish between deposits and investment instruments, as well as to facilitate the transition required to meet the minimum equity requirements set out in the equity program.

As recommended by the Task Force, a new class of shares will be created, to be known as common shares. These shares will form part of a credit union's equity and, as risk capital, will not be guaranteed by CUSC. Common shares will be of no par value, consistent with the Alberta Business Corporations Act, but will have an issue price of $25 or higher according to by-law. Certain exemptions from the minimum share value requirement may be permitted to provide the system with maximum flexibility to meet the equity requirements. All common shares must be fully paid up. Under the equity program, existing members will be expected to convert existing equity accounts or

membership shares to a minimum number of common shares within two years in order to remain a member.

Existing share savings accounts will be renamed "participatory savings accounts" and will be guaranteed by CUSC.

C. Loans to Members

Two basic controls will be placed on loans to members. Firstly, as the Task Force recommended, the legislation will prohibit members and connected members from collectively borrowing more than certain prescribed amounts. Connected members will include spouses, business partners, trusts or estates, or related corporate entities. Secondly, the practice of making loans to members and directors on concessionary terms will be prohibited. Transitional provisions for existing loans on a concessionary basis will be legislated. The primary objective is to ensure that no director receives more favourable loan terms by virtue of simply being a director. Loans to directors will be reported to the Board of Directors and to the membership. Employees may continue to receive loans on concessionary terms subject to the Regulations. In the future these transactions will be subject to the approval of the Board of Directors.

Summary and Conclusion

The Government of Alberta believes that large strides have been taken over the past two years in stabilizing and strengthening Alberta's credit union system. It is now timely to revise legislation which is nearly five decades old. The government invites the credit union system and interested parties to respond to this discussion paper prior to the tabling of legislation this Spring.

In summary, the government's proposals will:

- establish an equity building program.
- assign responsibility for incorporation, examinations, and the appointment of administrators to the Minister.
- confirm CUSC's responsibility for: guaranteeing deposits and participatory savings accounts; maintaining the integrity of the Stabilization Fund; implementing the equity program; and supervising or administering credit unions.

- confirm Central's role as manager of liquidity for the system.

- modernize existing legislation with respect to corporate self-governance.

- place controls on lending practices to assure system stability.

In spite of the difficulties facing the credit union system, the movement continues to play a vital role in the financial and economic well-being of the province. These reform proposals have been prepared not only in response to past difficulties but with a prospective view to maintaining and strengthening the competitiveness of the credit union system. Measures are designed to foster confidence in the credit union system, sustain the democratic principles underlying the movement, and to balance the desire to facilitate the economic development of members and customers with the safeguarding of members' funds.